AS REFLECTING NCI'S MOTION

Exhibit 58 —

Federal Order Hearing, Week of January 24, 2006
Docket No. AO-14-A74, et al.; DA-06-01
NMPF Statement in support of Proposal Number 1, its application to Class III and IV only; and the incorporation of Energy Costs Indices in the Final Rule

Introduction

My name is Roger Cryan. I have been Director of Economic Research for the National Milk Producers Federation (NMPF) for five years. Before that, I was the economist in the Atlanta Milk Market Administrator's office. I have a Ph.D. in agricultural economics from the University of Florida, I am a member of the Secretary of Agriculture's Advisory Committee on Agricultural Statistics, and I have been involved with agriculture and agricultural economics for twenty-five years.

NMPF is the voice of America's dairy farmers, representing over three-quarters of the country's 67,000 commercial dairy farmers through their memberships in NMPF's 33 member cooperative associations.

The National Milk Producers Federation supports the proposal of Agri-Mark, Inc., to adjust the manufacturing cost, or "make", allowances for cheddar cheese, nonfat dry milk, butter, and whey – the benchmark products in Federal order pricing – in order to account for rising costs and provide emergency relief to the manufacturers of these products. ~~NMPF asserts that these adjustments to the make allowances should only be applied to Class III and IV milk, since these benchmark products are all Class III and Class IV products. That is, the status quo should be maintained for the calculation of Class I and II prices~~. Further, NMPF urges that an indexing mechanism for energy costs be used to adjust these make allowances each month.

Background

Since 2000, manufacturers of cheddar cheese, butter, nonfat dry milk, and whey subject to Federal orders have faced manufacturing margins whose maxima are defined under Federal order price formulas. The "make allowances" for these products are the margin that their makers are allowed between the average surveyed price of their product and the minimum price they must pay to the producer pool for the milk they use to make those products.

The make allowances included in the current Federal order price formulas are derived from manufacturing cost surveys conducted in 1998. Those make allowances initially provided a reasonable return to the makers of those products. However, changes in the cost of production, most especially fluctuating energy prices, have made them less and less valid, until today they prejudice the ability of federally-regulated plants to compete with unregulated and state-regulated plants.

Federal order milk prices are *minimums*, so that if the demand for milk is strong enough, the market will produce price premiums above the USDA-set minimum. By contrast, make allowances define a *maximum* milk-to-cheese margin that the average

EXHIBIT 60
PENGAD-Bayonne, N. J.

cheddar cheese maker, for example, can get for his trouble. Since the current formulas define milk prices as a fixed function of the product prices, the milk price rises when the average product price rises. If the fixed margin becomes inadequate to cover costs for the average plant, there is no room for processing premiums. That is, while market forces can correct regulated milk prices that are too low, the make allowance can only be adjusted by USDA. Under current conditions, these make allowances are too low.

This undermines the ability of Federal order-regulated plants to operate. This, in turn, undermines Federal orders, which rely on manufacturing plants, including especially cooperative plants and cooperative-supplied plants, to balance overall milk supplies. If those outlets are pushed into state-regulated and unregulated markets, they cannot effectively provide those services, putting all participants in Federally-regulated markets at a disadvantage.

Following the especially sharp run-up in energy costs in recent years, there is general consensus that Federal order make allowances need adjustment.

NMPF Supports Two-Step Implementation of Proposal 1: Update and Index

We support Proposal 1 as noticed, and agree with the reasoning articulated by Agri-Mark in its original petition. The current Federal order price formulas contain fixed make allowances for manufacturers of cheddar cheese, whey, butter, and nonfat dry milk powder. When market prices increase for these benchmark products, the Federal order formulas dictate that they must automatically pay a higher price for their milk. Their margin is fixed, even if their costs rise. We agree with Agri-Mark that the current fixed make allowances have become increasingly inequitable, and support a change to the make allowances for Class III and Class IV milk handlers, as requested in the proposal.

We urge the implementation of this proposal through a two-step revision of the make allowances.

Update Costs

First, NMPF supports a recalculation of the underlying make allowances, using the cost of processing data from the regular survey conducted by the California Department of Food and Agriculture and comparable results of the recent survey conducted by USDA's Rural Business-Cooperative Service.

The data contained in these surveys should be combined according to the same basic methodology developed and used by USDA in the November 7, 2002, final decision. [67 FR 67913, *et seq.*] This methodology was well-justified in that decision [67 FR 67905-67947], and provides the soundest basis for a speedy decision in this proceeding. NMPF urges that USDA implement the recalculated make allowances immediately and on an emergency basis.

Index Energy

Second, NMPF urges the inclusion of a monthly indexing adjustment to the energy cost components of the recalculated make allowances. The most volatile element of cost, by far, has been energy. Increases in other costs have been more gradual, and have been partially offset by increased productivity in the manufacturing process. Energy price

increases in recent years have overshadowed other cost changes and gains in productivity. These increases have not been covered by the current fixed make allowance. The drastic rise and fall of these costs makes a one-time fixed increase in the make allowance inappropriate beyond an emergency interim decision. When energy prices rise dramatically, fixed make allowances would fail to provide adequately for plant costs; when they fall precipitously, they would provide an unfair windfall to processors at the expense of producers. NMPF therefore urges USDA to adopt a mechanism that would adjust the make allowances on a monthly basis for changes in energy costs, using the most recent Producer Prices Indexes for Industrial Electricity and Industrial Natural Gas.

Emergency Basis for Interim Final Decision

NMPF urges USDA to avoid unnecessary delay in implementing energy indexing; however, NMPF also acknowledges the need to provide manufacturers of the benchmark products with immediate relief from inadequate manufacturing cost allowances. For these reasons, NMPF asserts that USDA should proceed immediately and on an emergency basis through an interim final rule to implement recalculation of the make allowances based on updated 2004 costs. If, for some reason, the issue of adjusting for energy costs cannot be included in that interim final rule, then that issue should be subsequently addressed in the final rule that results from this proceeding.

In an attachment to this statement we have included proposed language that would effect the make allowance revisions that we are recommending, including language for an interim final rule that would not include provisions for energy cost indexing.

Applying Make Allowance Increases to Classes III & IV Only

The emergency conditions that led to this hearing demand relief for the processors of butter, nonfat dry milk, cheddar cheese, and dry whey; because these are the products to which the make allowances directly apply. Regulated makers of these four products cannot increase their average sale price without increasing their raw milk cost through the Federal order price formula. The emergency decision called for should be applied only to the Classes in which those products fall – Class III and Class IV.

It would be inequitable to cut Class I and II prices to producers as an unnecessary by-product of relief for Class III and IV processors. The market for Class I and II dairy products will bear price increases when margins are insufficient. For example, if the costs faced by the manufacturers of ice cream or the bottlers of drinking milk rise, the market will bear higher prices without having a direct impact on their cost of milk.

Producers and their cooperatives have also faced rising costs in supplying Class I and Class II markets, and reducing Class I and II prices relative to the underlying dairy markets would be an unfair imposition. Indeed, the rising fuel costs faced by dryers of nonfat milk and whey represent a large part of the make allowance increases. Such costs do not affect Class I and II in the same way; indeed, they affect the producers and cooperatives who pay for the transportation of raw milk much more. Class I milk is shipped longer distances than ever before, and this is made still more expensive by rising fuel costs. Such a changes to the Class I and II price calculations should only be made in the context of a general and comprehensive re-examination of class prices.

Table 1. Manufacturing Cost Data and Make Allowance Calculation

Dairy Product Plant Costs for 2004, USDA/RBS-CS, revised 01-13-06, $/lb.

	Cheese	Butter	Powder	Whey
Mil. Lbs.	*414.34*	*254.12*	*439.04*	*357.11*
Total, wtd. avg., $/lb.	0.15136	0.16588	0.16816	0.11409
Add CDFA ROI, $/lb.	0.00820	0.00660	0.00785	0.03980
Add CDFA Adm., $/lb.	0.02030	0.01510	0.01049	0.00260
Butter pkg. adj. (CDFA-RBCS), $/lb.		-0.01769		
Adj. Wtd. Avg., $/lb.	0.17986	0.16989	0.18650	0.15649

Dairy Product Plant Costs for 2004, CDFA, revised 01-13-06, $/lb.

	Cheese	Butter	Powder*	Whey
Mil. Lbs.	*817.07*	*382.93*	*706.55*	*93.27*
Total Wtd. Avg., $/lb.	0.1769	0.1368	0.1495	0.2673

Dairy Product Plant Costs, CDFA & USDA/RBS-CS, Wtd. Avg., 2004, $/lb.

	Cheese	Butter	Powder	Whey
Mil. Lbs.	*1231.41*	*637.05*	*1145.58*	*450.39*
Wtd. Avg.	0.17790	0.15000	0.16368	0.17944
Add $.0015 Mktg.	0.0015	0.0015	0.0015	0.0015
Adj. Wtd. Avg.	0.17940	0.15150	0.16518	0.18094
Current Make Allowance	0.16500	0.11500	0.14000	0.15900

Producer Price Indexes				
Industrial Electricity PPI 1998	130	130	130	130
Industrial Electricity PPI 2004	147.2	147.2	147.2	147.2
Industrial Electricity PPI, 11/05	161.5	161.5	161.5	161.5
Industrial Natural Gas PPI 1998	103.6	103.6	103.6	103.6
Industrial Natural Gas PPI 2004	201.7	201.7	201.7	201.7
Industrial Natural Gas PPI 11/05	315.6	315.6	315.6	315.6

2004 Make Costs, $/lb.	Cheese	Butter	Powder*	Whey
Electricity (RBCS/CDFA avg.)	0.00714	0.00912	0.01511	0.01493
Fuels (RBCS/CDFA avg.)	0.00772	0.00492	0.02951	0.02266
Other (residual)	0.16454	0.13746	0.12056	0.14336
Adj. Wtd. Avg.	**0.17940**	**0.15150**	**0.16518**	**0.18094**
Change from Current	***0.01440***	***0.03650***	***0.02518***	***0.02194***

2004 Make Costs, $/lb. adjusted for Nov 2005 Energy Prices				
Electricity	0.00783	0.01000	0.01658	0.01638
Fuels	0.01208	0.00770	0.04617	0.03545
Other	0.16454	0.13746	0.12056	0.14336
Adj. Wtd. Avg.	**0.18445**	**0.15517**	**0.18331**	**0.19518**
Change from Current	***0.01945***	***0.04017***	***0.04331***	***0.03618***

2004 Make Costs, $/lb. adjusted for 1998 Energy Prices				
Electricity	0.00630	0.00805	0.01334	0.01318
Fuels	0.00396	0.00253	0.01516	0.01164
Other	0.16454	0.13746	0.12056	0.14336
Adj. Wtd. Avg.	**0.17481**	**0.14804**	**0.14906**	**0.16818**
Change from Current	***0.00981***	***0.03304***	***0.00906***	***0.00918***

Production	Cheese	Butter	Powder*	Whey
In surveys, mil. lbs.	1231.41	637.05	1145.58	450.39
NASS total, mil. lbs.	3004.427	1249.678	1406.39	992.48
Share in surveys	**41%**	**51%**	**81%**	**45%**

* Excludes high-cost nonfat dry milk makers in CDFA survey.

Applying increased make allowances to Class I and II milk will unnecessarily reduce producer revenue, providing a windfall to processors of Class I and II products, who do not face binding constraints in the Federal order make allowances, whose cost structure differs substantially for that of Class III and IV processors, and who do not require (and had not requested) emergency relief.

Ideally, any increase in the make allowances would be applied only to the makers of the benchmark products, but this is impracticable. What is practicable is to limit the make allowance increases to Class III and IV milk. Reductions in the Class I and II prices do not need to follow from the emergency relief for manufacturers of benchmark products.

Language to this effect is attached to this statement. This may be accomplished simply by restating the current formulas in the price definitions for Class I and Class II milk and components. This is a simple and "appropriate modification", as provided for in the hearing notice, to maintain the status quo with respect to Class I and II pricing. Retaining the current pricing for Class I and II milk should not interfere with timely relief for makers of cheese, butter, nonfat dry milk, and dry whey.

Further, recalculating the make allowances for Class I and II milk is not an incidental issue. Some 58% of milk pooled in the Federal orders in 2004 was Class I and II. The negative impact on producer income of increased make allowances on Class I and II would reasonably be expected to exceed the impacts of the adjustments to Class III and IV alone. If this is correct, the impact on the all-milk price could be reduced from the 3¢ in USDA's projected Scenario 1 to just over 1¢ per hundredweight in a Scenario 1 with indexing and applied to Class III and IV only.

Again, this decision should be narrowly targeted to meet the emergency faced by processors of certain Class III and IV products, and should be applied to those Classes.

For all these reasons, NMPF urges USDA to increase the make allowances for Class III and Class IV milk and milk components only. No changes should be applied to the calculation of Class I and II milk prices unless justified after specific consideration of argument and evidence on that issue in some future proceeding.

Updating Surveyed Cost Data

A dairy product price-based formula for milk prices depends upon a reasonable make allowance, which in turn depends upon good cost of processing data. As mentioned previously, the cost of processing data upon which the current Federal order make allowances are based were, mostly, data reflecting 1998 plant operations. The data sources used at the May 2000 hearing were the annual dairy product manufacturing costs survey conducted by the California Department of Food and Agriculture (CDFA), and a similar but voluntary survey conducted by K. Charles Ling of United States Department of Agriculture's Rural Business-Cooperative Service (RBCS). [67 FR 67913, *et seq.*]

This data is now eight years old, and inadequately represents the costs of processing in 2006. As a result, the current make allowances impose an undue burden upon processors, as previously explained and as demonstrated by a comparison of the current make allowances with the estimated equivalent costs of processing. (See Table 1.)

CDFA Survey

The California Department of Food and Agriculture conducts an annual cost of dairy processing survey in order to define make allowances in minimum price formulas very similar to those used in the Federal orders. This survey is audited and participation by California processors is nearly 100% for butter, powder, and cheese, and nearly 80% for whey. (See Exhibit 25.)

The most recent results of this survey were released on November 18, 2005, and amended on January 13, 2006. This data is based upon "unadjusted cost studies for periods between January and December 2004." The amended survey results are summarized in context in Table 1.

RBCS Survey

K. Charles Ling of the USDA's Rural Business-Cooperative Service conducts a periodic cost of dairy processing survey as technical assistance to participating dairy farmer cooperative associations. Revised data from this survey was also released on January 13, 2006. This data is based upon a voluntary survey of dairy farmer cooperative associations that process cheese, nonfat dry milk, butter, and dry whey.

Methodology for Pooling Survey Data

The CDFA and RBCS surveys provide non-overlapping data of comparable value. Taken together, they are representative of U.S. processors of cheddar cheese (surveyed plants represent 41% of U.S. production), butter (51%), nonfat dry milk (81%, even after excluding the high-cost California plants, see below) and dry whey (45%).

The data contained in these surveys should be combined according to the same methodology developed by USDA and used in the November 7, 2002, final decision [67 FR 67913, *et seq.*], with a single, minor exception.

In 2002, the lower-cost group of butter plants from the California survey was excluded from the calculation of the average plant cost. [67 FR 67920] The butter plants in the California survey are still presented by CDFA in two groups, but the lower-cost group represents more than 75% of the total volume surveyed in California, more than 45% of the total volume in both surveys, and 23% of total U.S. butter production. [USDA, National Agricultural Statistics Service; *Dairy Products*, January 2006, available at http://usda.mannlib.cornell.edu/reports/nassr/dairy/pdp-bb/2006/dary0106.pdf] We believe that the justification for excluding this volume no longer exists, as it appears to be representative of a very large share of U.S. butter production and of the available data. NMPF's calculation of the updated make allowance, which is included in Table 1, does not exclude data about this group. This is the only departure that we propose to make from the 2002 USDA methodology.

In 2002, the highest-cost group of nonfat dry milk plants was similarly excluded as generally unrepresentative of nonfat dry milk production at market balancing plants, partly because their exceptionally high costs and small size suggested that they were statistical outliers. [67 FR 67921] Since these 3 plants represent less than 3% of U.S. production [USDA, National Agricultural Statistics Service; *Dairy Products*, January

2006, available at http://usda.mannlib.cornell.edu/reports/nassr/dairy/pdp-bb/2006/dary0106.pdf] and just over 3% of the production captured in the two surveys, it is reasonable to continue to exclude them for the same reasons that they were excluded in 2002. Our calculation of the make allowance in Table 1 excludes data regarding this group.

In 2002, the RBCS packaging materials costs for butter were replaced with those from the CDFA survey. [67 FR 67920] This was based on the existence of a large volume of print butter in the RBCS survey, whereas the CDFA survey included only bulk butter. Since the product price formula is based upon bulk butter prices, the CDFA packaging materials cost was considered more appropriate. Since 44% of the butter in the RBCS survey of 2004 costs were prints, this rationale still holds. NMPF's calculation of the make allowance in Table 1 continues to use the butter packaging cost data from the CDFA survey.

In 2002, the appropriate CDFA numbers for "return on investment" and "general & administrative costs" were added to the RBCS numbers. We have done the same in our calculations. [67 FR 67913]

Conservative Increases

NMPF believes that any increases in the fixed components of the make allowance should be conservative. It has been asserted by some that yield improvements in manufacturing, based perhaps on such marginal improvements as decreased shrinkage in handling, may partially offset some of the cost increases captured in the survey data. To the extent that there are other uncertainties in the reapplication of the methodology used in 2002, USDA should err on the side of a more conservative increase. We anticipate that a more complete consideration of all elements of the price formulas will be taken up in a future proceeding.

Emergency Basis for Updating Cost Data

The proposal to recalculate the make allowances using updated 2004 survey costs should be addressed and implemented immediately and on an emergency basis. The methodology of the 2002 decision was well-justified in the course of that proceeding. [67 FR 67905-67947] Any major deviation from that original approach could well delay the implementation of an interim final decision.

As stated above, Federally-regulated plants processing the four benchmark products are at a considerable disadvantage to unregulated plants, and are generally unable to cover their competitive costs. For this reason, an emergency decision is called for.

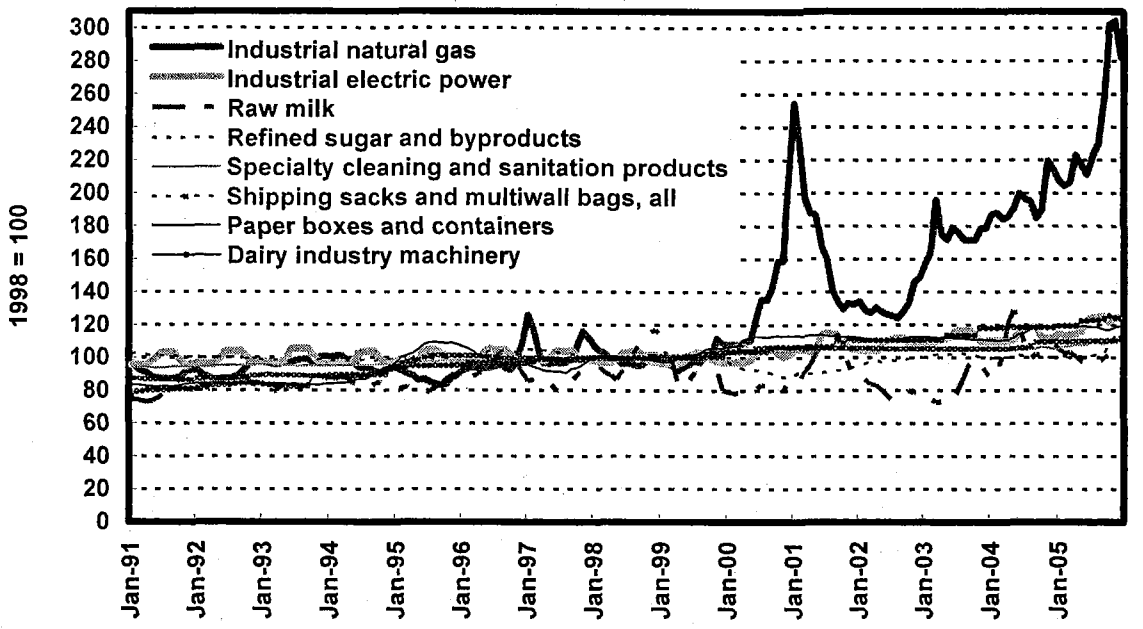
Indexing Energy Costs in the Federal Order Make Allowances

Of all components of manufacturing costs, the most volatile by far are energy costs. These can swing violently, while such costs as labor, sewage, laundry, and insurance tend to move slowly and consistently. (See Figure 1.[1]) A fixed make allowance, such as the

[1] The chart shows the following published PPI data series, all adjusted so the annual average for 1998 is equal to 100: WPU016, WPU023103, WPU02320114, WPU023302, WPU023502, WPU0253, WPU0543,

current one, depends upon an estimated energy cost at a single point in time. If the current make allowances for whey and nonfat dry milk were adjusted for increases in electricity and natural gas costs increases since 1998, they would now be higher than the updated costs as calculated above. On the other hand, if a fixed increase were to be implemented on the basis of the extraordinarily high energy costs incurred in late 2005, for example, the resulting make allowance is likely to be excessive in the near future, as energy prices are expected to regress toward their long-term norms.

Figure 1. Producer Price Indexes, Selected Processing Inputs



Source: Bureau of Labor Statistics

A regular adjustment to this highly volatile element of the cost of dairy processing is the best way to maintain equity between producers and the processors of the benchmark products.

In the interests of equity and of maintaining each market's capacity for balancing, the Federation urges that the Final Rule that results from this proceeding include formulas to provide for monthly adjustments of processors' energy costs, based on published Producer Price Indexes. Such indexing would allow specific and regular adjustments – both up and down – to reflect changes in plants' costs of natural gas and electricity.

NMPF recommends that the energy index adjustments be calculated from the Producer Price Indexes for Industrial Natural Gas (BLS Series WPU0553, Base = Dec 1990)[2] and Industrial Electric Power Distribution (BLS Series WPU0543, Base = 1982), weighted by the direct costs of electricity and fuels per pound of product, as estimated for

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WPU0553, WPU06720102, WPU09150218, WPU091503, WPU116101. They may be most easily retrieved from the following Bureau of Labor Statistics web page: http://data.bls.gov/cgi-bin/srgate

[2] Another natural gas PPI, WPU0531, tracks the price of natural gas at the wellhead or, where it is a by-product of other processing, at the processing plants. This has been confirmed by personal communication with Melissa Wolter of the Bureau of Labor Statistics.

2004 by USDA/RBS and CDFA. In order to adjust the costs measured for 2004 by CDFA and RBCS, the 2004 annual average would be used as a base. The 2004 annual average PPI was 201.7 for Utility Natural Gas and 147.2 for Industrial Electricity Distribution.

Although a modest one-time adjustment could move the formulas closer to equity under current conditions, a new fixed make allowance could already be out of date when it is implemented. It will unfairly penalize processors when input prices go above the baseline in the revised survey, and unfairly penalize producers when input prices go below the baseline. An energy cost indexing element can and should be added to the formula.

Calculating the Energy Cost Adjustment

Once the make allowances are updated with the 2004 survey data, we recommend adjusting them each month to account for the often violent rise and fall of energy costs. We recommend that the Electricity and Fuels elements of plant costs be inflated or deflated according to the following formula:

$$\textit{Make adjustment} =$$

$$[\ (\textit{Industrial Electricity } PPI_{current}/\textit{Industrial Electricity } PPI_{2004}) - 1]\ *\ \textit{Electricity } Cost_{2004}$$

$$+\ [\ (\textit{Industrial Natural Gas } PPI_{current}/\textit{Industrial Natural Gas } PPI_{2004}) - 1)\ *\ \textit{Fuels } Cost_{2004}$$

The energy costs to be inflated could be averaged from the RBS-CS survey and the CDFA survey or, if CDFA data is not offered at this hearing, taken directly from the RBCS survey. (See below.)

The objective of the formula is to adjust the energy components of the cost of processing for each benchmark commodity. Energy is by far the most volatile element of processing cost. Automatic adjustments to energy costs will cause the make allowance to more consistently reflect the costs that it is intended to reflect. The resulting make allowance would be neither too high nor too low, as energy costs swing up and down.

Setting the Energy Cost Base

Average 2004 electricity and fuels costs from RBCS and CDFA can be used as the base for this adjustor. The following 2004 data were compiled by RBCS and CDFA[3], and are used to calculate a volume-weighted average of the two sets, which we propose to use as the energy cost adjustment factor in the make allowance formula.

[3] The CDFA energy cost data was communicated informally and indirectly by CDFA; we defer to CDFA to confirm their official release and verify their accuracy.

Table 2 shows average plant costs of electricity and fuels from the RBCS and CDFA surveys, excluding the high-cost powder plants in the CDFA survey, and an average of the two, weighted by the volume of each product in each survey. We recommend these numbers as the best use of the available data to establish a baseline set of energy costs.

Table 2. Dairy Product Plant Costs, 2004, $/Lb.

USDA/RBCS

Cost items	Cheese	Butter	Powder	Whey
Electricity	0.0043	0.0091	0.0121	0.0101
Fuels	0.0076	0.0095	0.0382	0.0227

CDFA

Cost items	Cheese	Butter	Powder	Whey
Electricity	0.0086	0.0091	0.0170	0.0334
Fuels	0.0078	0.0019	0.0241	0.0226

Weighted Average of CDFA and RBCS

Cost items	Cheese	Butter	Powder	Whey
Electricity	0.0071	0.0091	0.0151	0.0149
Fuels	0.0077	0.0049	0.0295	0.0227

Sources: USDA/RBCS, CDFA

Use of Industrial Natural Gas and Industrial Electricity PPI's

Producer Price Indices are published by the Bureau of Labor Statistics (BLS) as a measure of changes in the prices of a large number of inputs to production. The prices for some inputs are measured separately for residential customers, commercial customers, and industrial customers. Industrial customers include manufacturing and mining. These Indexes are published monthly, in mid-month.

The Producer Price Index for Industrial Natural Gas is designated as BLS Series WPU0553. Its base period is December 1990; that is, the index is set equal to 100 for that month. This series tracks the average price of natural gas sold by utilities to industrial customers, defined as manufacturing and mining operations. A note from the economist who works most directly with the Producer Price Index at BLS is attached; the detail of this note clearly distinguishes the Industrial Natural Gas index as the one most directly applicable to manufacturers costs of energy.

The Producer Price Index for Industrial Electric Power Distribution is designated as BLS Series WPU0543. Its base period is 1982; that is, the index is set equal to 100 for the annual average of 1982. This series tracks the average price of electricity sold by utilities to industrial customers, defined as manufacturing and mining operations.

Both of these series can be retrieved from the following page in the website of the Bureau of Labor Statistics using their Series ID numbers:

http://data.bls.gov/cgi-bin/srgate

In order to adjust the costs measured for 2004 by CDFA and RBCS, the 2004 annual average should be used as a base, as in the formula above and in the attached language. The 2004 annual average PPI was 201.7 for Utility Natural Gas and 147.2 for Industrial Electricity Distribution.

Evidence for Applicability of an Energy Cost Adjustors

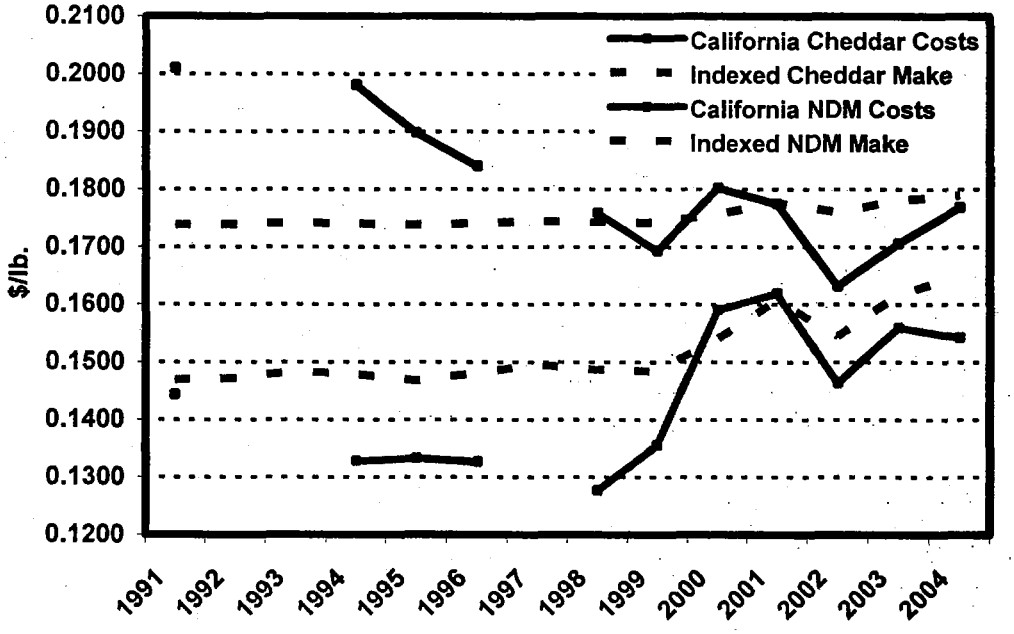
The only consistent series of manufacturing costs over time is for California. This series provides a means of testing the fit of proposed energy cost adjustments to the make allowance.

The graph below shows the annual California cost survey results for cheddar cheese, and nonfat dry milk, along with make allowances for each adjusted with our proposed

electricity and natural gas adjustors. Although the energy costs don't account for all of the long-term changes in manufacturing costs, they do appear to clearly account for much of the year-to-year variation. (The annual California costs of processing are

Energy – especially natural gas – costs are a large share of the cost of processing of nonfat dry milk. Cheese costs in California have been trending downward over 15 years. This long-term trend may or may not be representative of the nation at large. Nevertheless, the proposed make allowance adjustment does reflect much of the year-to-year variation in California cheese processing costs. The graph shows how closely an adjusted make allowance fits the changes in California costs for cheese and nonfat dry milk.

Figure 2. Indexed Make Allowances and California Costs



Sources: CDFA, BLS

The proposed butter cost adjustment also correlates with changing costs in California butter plants, but uniquely among these products, non-energy costs have risen considerably more than energy costs, so that it does not show up easily in a simple graph.

California whey costs were not collected before 2003. For this reason, we are unable to directly test the fit over time of our proposed energy index for whey, as we have for butter, nonfat dry milk, and cheese. However, whey drying is so similar to nonfat dry milk production that we can reasonably assume, as USDA did in order reform and the 2002 decision, that whey processing costs are closely related to nonfat dry milk processing costs. We suggest that the evidence for nonfat dry milk also represents evidence for whey.

Monthly Application of Energy Cost Adjustor

The energy price indexes that we propose to be used are calculated each month by the Bureau of Labor Statistics. The make allowance should be as current as possible by monthly updating. This would provide for smaller month to month changes than if

adjustments were made quarterly or annually. Just as the milk price formulas are calculated and applied each month as a formula of the dairy product prices, so should an energy cost formula be calculated and applied each month in the revised formulas.

Conclusion

Processing costs from 1998 are not an appropriate basis for calculating make allowances in 2006. However, a single fixed adjustment for all costs will almost certainly be either inadequate to processors or inequitable to producers within months of its implementation. The formulas need to be adjusted not only to reflect more current costs, but also to take into account continuing fluctuations in energy costs. The use of an energy price index in the formula is the best and fairest way to deal with this issue.

Revised make allowances with energy cost indexing would provide specific relief to plants squeezed by higher energy costs, then reduce make allowances again when the squeeze is off.

This hearing is being held on an emergency basis to provide relief to manufacturers of the benchmark products whose prices are used to set minimum milk prices, and this relief should be provided as soon as possible. If this requires that an interim final rule be issued without indexing, NMPF would support the issuance of such an interim rule. However, only the application of indexing for energy costs can ultimately ensure that make allowances are fair and equitable. ~~Similarly, equity demands that increased make allowances be applied only to Class III and IV milk, since the emergency faced by benchmark manufacturers does not bear on Class I and II handlers.~~

We urge Dairy Programs and the Secretary of Agriculture to target this decision to the emergency at hand by issuing a prompt interim final rule to adjust make allowances with 2004 data, ~~by applying these adjustments to Class III and IV milk only,~~ and by implementing energy cost indexing in this proceeding's final rule.

APPENDIX

Language for Final Rule with Indexing

Language for a Possible Interim Rule without Indexing

Proposed Language for Final Rule (with Indexing)

The following language is proposed to effect the revision of the make allowances and indexing of energy costs in the Class III and IV milk and milk component price formulas. No conforming changes would be required outside of this section.

§ 1000.50 Class prices, component prices, and advanced pricing factors.

Class prices per hundredweight of milk containing 3.5 percent butterfat, component prices, and advanced pricing factors shall be as follows. The prices and pricing factors described in paragraphs (a), (b), (c), (e), (f), and (q) of this section shall be based on a weighted average of the most recent 2 weekly prices announced by the National Agricultural Statistical Service (NASS) before the 24th day of the month. These prices shall be announced on or before the 23rd day of the month and shall apply to milk received during the following month. The prices described in paragraphs (g) through (p) of this section shall be based on a weighted average for the preceding month of weekly prices announced by NASS on or before the 5th day of the month and shall apply to milk received during the preceding month. The price described in paragraph (d) of this section shall be derived from the Class II skim milk price announced on or before the 23rd day of the month preceding the month to which it applies and the butterfat price announced on or before the 5th day of the month following the month to which it applies.

(a) Class I price. The Class I price per hundredweight, rounded to the nearest cent, shall be .965 times the Class I skim milk price plus 3.5 times the Class I butterfat price.

(b) Class I skim milk price. The Class I skim milk price per hundredweight shall be the adjusted Class I differential specified in § 1000.52 plus the higher of the advanced pricing factors computed in paragraph (q)(1) or (2) of this section.

(c) Class I butterfat price. The Class I butterfat price per pound shall be the adjusted Class I differential specified in § 1000.52 divided by 100, plus the advanced butterfat price computed in paragraph (q)(3) of this section.

(d) The Class II price per hundredweight, rounded to the nearest cent, shall be .965 times the Class II skim milk price plus 3.5 times the Class II butterfat price.

(e) Class II skim milk price. The Class II skim milk price per hundredweight shall be the advanced Class IV skim milk price computed in paragraph (q)(2) of this section plus 70 cents.

(f) Class II nonfat solids price. The Class II nonfat solids price per pound, rounded to the nearest one-hundredth cent, shall be the Class II skim milk price divided by 9.

(g) ~~Class II butterfat price~~. The Class II butterfat price per pound, **rounded to the nearest one-hundredth cent,** shall be **the U.S. average NASS AA Butter survey price reported by the Department for the month less 11.5 cents, with the result multiplied by 1.2,** ~~butterfat price~~ plus $.007.

(h) Class III price. The Class III price per hundredweight, rounded to the nearest cent, shall be .965 times the Class III skim milk price plus 3.5 times the butterfat price.

(i) Class III skim milk price. The Class III skim milk price per hundredweight, rounded to the nearest cent, shall be the protein price per pound times 3.1 plus the other solids price per pound times 5.9.

(j) Class IV price. The Class IV price per hundredweight, rounded to the nearest cent, shall be .965 times the Class IV skim milk price plus 3.5 times the butterfat price.

(k) Class IV skim milk price. The Class IV skim milk price per hundredweight, rounded to the nearest cent, shall be the nonfat solids price per pound times 9.

(l) Butterfat price. The butterfat price per pound, rounded to the nearest one-hundredth cent, shall be:

(1) The U.S. average NASS AA Butter survey price reported by the Department for the month,

(2) less **a manufacturing cost allowance equal to:**

(i) 15.1 cents **plus**,

(ii) 0.5 cents times a figure equal to the latest monthly Producer Price Index for Industrial Natural Gas reported by the Bureau of Labor Statistics minus 201.7 and divided by 201.7, plus

(iii) 0.9 cents times a figure equal to the latest monthly Producer Price Index for Industrial Electricity reported by the Bureau of Labor Statistics minus 147.2 and divided by 147.2;

(3) with the result multiplied by 1.20.

(m) Nonfat solids price. The nonfat solids price per pound, rounded to the nearest one-hundredth cent, shall be

(1) The U.S. average NASS nonfat dry milk survey price reported by the Department for the month,

(2) less **a manufacturing cost allowance equal to:**

(i) 16.5 cents **plus**,

(ii) 3.0 cents times a figure equal to the latest monthly Producer Price Index for Industrial Natural Gas reported by the Bureau of Labor Statistics minus 201.7 and divided by 201.7, plus

(iii) 1.5 cents times a figure equal to the latest monthly Producer Price Index for Industrial Electricity reported by the Bureau of Labor Statistics minus 147.2 and divided by 147.2;

(3) with the result multiplied by .99.

(n) Protein price. The protein price per pound, rounded to the nearest one-hundredth cent, shall be computed as follows:

(1) Compute a weighted average of the amounts described in paragraphs (n)(1)(i) and (ii) of this section:

(i) The U.S. average NASS survey price for 40-lb. block cheese reported by the Department for the month; and

(ii) The U.S. average NASS survey price for 500-pound barrel cheddar cheese (38 percent moisture) reported by the Department for the month plus 3 cents;

(2) **From the price computed pursuant to paragraph (n)(1) of this section** subtract **a manufacturing cost allowance equal to:**

(i) 17.9 cents**, plus** ~~**from the price computed pursuant to paragraph (n)(1) of this section and multiply the result by 1.383;**~~

(ii) 0.7 cents times a figure equal to the latest monthly Producer Price Index for Industrial Natural Gas reported by the Bureau of Labor Statistics minus 201.7 and divided by 201.7, plus

(iii) 0.8 cents times a figure equal to the latest monthly Producer Price Index for Industrial Electricity reported by the Bureau of Labor Statistics minus 147.2 and divided by 147.2;

(3) **Multiply** ~~**Add to**~~ the amount computed pursuant to paragraph (n)(2) of this section **by 1.383, then** an amount computed as follows:

(i) Subtract **the manufacturing cost allowance computed pursuant to paragraph (n) (2) of this section** ~~**16.5 cents**~~ from the price computed pursuant to paragraph (n)(1) of this section and multiply the result by 1.572;

(ii) Subtract 0.9 times the butterfat price computed pursuant to paragraph (l) of this section from the amount computed pursuant to paragraph (n)(3)(i) of this section; and

(iii) Multiply the amount computed pursuant to paragraph (n)(3)(ii) of this section by 1.17.

(o) Other solids price. The other solids price per pound, rounded to the nearest one-hundredth cent, shall be

(1) The U.S. average NASS dry whey survey price reported by the Department for the month,

(2) less **a manufacturing cost allowance equal to:**

(i) 18.1 cents **plus,**

(ii) 2.3 cents times a figure equal to the latest monthly Producer Price Index for Industrial Natural Gas reported by the Bureau of Labor Statistics minus 201.7 and divided by 201.7, plus

(iii) 1.5 cents times a figure equal to the latest monthly Producer Price Index for Industrial Electricity reported by the Bureau of Labor Statistics minus 147.2 and divided by 147.2;

(3) with the result multiplied by 1.03.

(p) Somatic cell adjustment. The somatic cell adjustment per hundredweight of milk shall be determined as follows:

(1) Multiply .0005 by the weighted average price computed pursuant to paragraph (n)(1) of this section and round to the 5th decimal place;

(2) Subtract the somatic cell count of the milk (reported in thousands) from 350; and

(3) Multiply the amount computed in paragraph (p)(1) of this section by the amount computed in paragraph (p)(2) of this section and round to the nearest full cent.

(q) Advanced pricing factors. For the purpose ~~of computing the~~ Class I skim milk price, the Class II skim milk price, the Class II nonfat solids price, and the Class I butterfat price for the following month, the following pricing factors shall be computed using the weighted average of the 2 most recent NASS U.S. average weekly survey prices announced before the 24th day of the month:

(1) An advanced Class III skim milk price per hundredweight, rounded to the nearest cent, shall be computed as follows:

(i) ~~**Following the procedure set forth in paragraphs (n) and (o) of this section, but u**~~ Using the weighted average of the 2 most recent NASS U.S. average weekly survey prices announced before the 24th day of the month, compute a protein price and an other solids price **as follows:**

(A) A protein price per pound, rounded to the nearest one-hundredth cent, shall be computed as follows:

(I) Compute a weighted average of the amounts described in paragraphs (q)(1)(i)(A)(I)(*a*) and (*b*) of this section:

(*a*) The weighted average of the 2 most recent U.S. average NASS survey prices for 40-lb. block cheese announced before the 24th day of the month; and

(*b*) The weighted average of the 2 most recent U.S. average NASS survey prices for 500-pound barrel cheddar cheese (38 percent moisture) announced before the 24th day of the month;

(II) Subtract 16.5 cents from the price computed pursuant to paragraph (q)(1)(i)(A)(I) of this section and multiply the result by 1.383;

(III) Add to the amount computed pursuant to paragraph (q)(1)(i)(A)(II) of this section an amount computed as follows:

(*a*) Subtract 16.5 cents from the price computed pursuant to paragraph (q)(1)(i)(A)(I) of this section and multiply the result by 1.572;

(*b*) Subtract 0.9 times the butterfat price computed pursuant to paragraph (q)(3) of this section from the amount computed pursuant to paragraph (q)(1)(i)(A)(III)(*a*) of this section; and

(*c*) Multiply the amount computed pursuant to paragraph (q)(1)(i)(A)(III)(*b*) of this section by 1.17.

(B) An other solids price per pound, rounded to the nearest one-hundredth cent, shall be calculated by computing a weighted average of the 2 most recent U.S. average NASS dry whey survey prices announced before the 24th day of the month, subtracting 15.9 cents from this average, and multiplying the result by 1.03. ;

~~(ii) Multiply the protein price computed in paragraph (q)(1)(i) of this section~~ by 3.1;

(iii) Multiply the other solids price per pound computed in paragraph (q)(1)(i) of this section by 5.9; and

(iv) Add the amounts computed in paragraphs (q)(1)(ii) and (iii).

(2) An advanced Class IV skim milk price per hundredweight, rounded to the nearest cent, shall be computed as follows:

(i) ~~Following the procedure set forth in paragraph (m) of this section, but u~~ Using the weighted average of the 2 most recent NASS U.S. average weekly survey prices announced before the 24th day of the month, ~~compute a~~ the advanced nonfat solids price shall be the NASS nonfat dry milk survey price reported by the department less 14 cents, with the result multiplied by 0.99.; ~~and~~

(ii) Multiply the advanced nonfat solids price computed in paragraph (q)(2)(i) of this section by 9.

(3) An advanced butterfat price per pound, rounded to the nearest one-hundredth cent, shall be calculated by computing a weighted average of the 2 most recent U.S. average NASS AA Butter survey prices announced before the 24th day of the month, subtracting 11.5 cents from this average, and multiplying the result by 1.20.

Proposed Language for Interim Final Rule without Indexing, if such is required.

The following language is proposed to effect the revision of the make allowances in the Class III and IV milk and milk component price formulas. No conforming changes would be required outside of this section.

§ 1000.50 Class prices, component prices, and advanced pricing factors.

Class prices per hundredweight of milk containing 3.5 percent butterfat, component prices, and advanced pricing factors shall be as follows. The prices and pricing factors described in paragraphs (a), (b), (c), (e), (f), and (q) of this section shall be based on a weighted average of the most recent 2 weekly prices announced by the National Agricultural Statistical Service (NASS) before the 24th day of the month. These prices shall be announced on or before the 23rd day of the month and shall apply to milk received during the following month. The prices described in paragraphs (g) through (p) of this section shall be based on a weighted average for the preceding month of weekly prices announced by NASS on or before the 5th day of the month and shall apply to milk received during the preceding month. The price described in paragraph (d) of this section shall be derived from the Class II skim milk price announced on or before the 23rd day of the month preceding the month to which it applies and the butterfat price announced on or before the 5th day of the month following the month to which it applies.

(a) Class I price. The Class I price per hundredweight, rounded to the nearest cent, shall be .965 times the Class I skim milk price plus 3.5 times the Class I butterfat price.

(b) Class I skim milk price. The Class I skim milk price per hundredweight shall be the adjusted Class I differential specified in § 1000.52 plus the higher of the advanced pricing factors computed in paragraph (q)(1) or (2) of this section.

(c) Class I butterfat price. The Class I butterfat price per pound shall be the adjusted Class I differential specified in § 1000.52 divided by 100, plus the advanced butterfat price computed in paragraph (q)(3) of this section.

(d) The Class II price per hundredweight, rounded to the nearest cent, shall be .965 times the Class II skim milk price plus 3.5 times the Class II butterfat price.

(e) Class II skim milk price. The Class II skim milk price per hundredweight shall be the advanced Class IV skim milk price computed in paragraph (q)(2) of this section plus 70 cents.

(f) Class II nonfat solids price. The Class II nonfat solids price per pound, rounded to the nearest one-hundredth cent, shall be the Class II skim milk price divided by 9.

(g) Class II butterfat price. The ~~Class II butterfat price~~ per pound, **rounded to the nearest one-hundredth cent,** shall be **the U.S. average NASS AA Butter survey price reported by the Department for the month less 11.5 cents, with the result multiplied by 1.2,** ~~**butterfat price**~~ plus $.007.

(h) Class III price. The Class III price per hundredweight, rounded to the nearest cent, shall be .965 times the Class III skim milk price plus 3.5 times the butterfat price.

(i) Class III skim milk price. The Class III skim milk price per hundredweight, rounded to the nearest cent, shall be the protein price per pound times 3.1 plus the other solids price per pound times 5.9.

(j) Class IV price. The Class IV price per hundredweight, rounded to the nearest cent, shall be .965 times the Class IV skim milk price plus 3.5 times the butterfat price.

(k) Class IV skim milk price. The Class IV skim milk price per hundredweight, rounded to the nearest cent, shall be the nonfat solids price per pound times 9.

(l) Butterfat price. The butterfat price per pound, rounded to the nearest one-hundredth cent, shall be the U.S. average NASS AA Butter survey price reported by the Department for the month, less **15.2** cents with the result multiplied by 1.20.

(m) Nonfat solids price. The nonfat solids price per pound, rounded to the nearest one-hundredth cent, shall be the U.S. average NASS nonfat dry milk survey price reported by the Department for the month, less **16.5** cents, with the result multiplied by 0.99.

(n) Protein price. The protein price per pound, rounded to the nearest one-hundredth cent, shall be computed as follows:

(1) Compute a weighted average of the amounts described in paragraphs (n)(1)(i) and (ii) of this section:

(i) The U.S. average NASS survey price for 40-lb. block cheese reported by the Department for the month; and

(ii) The U.S. average NASS survey price for 500-pound barrel cheddar cheese (38 percent moisture) reported by the Department for the month plus 3 cents;

(2) Subtract **17.9** ~~16.5~~ cents from the price computed pursuant to paragraph (n)(1) of this section and multiply the result by 1.383;

(3) Add to the amount computed pursuant to paragraph (n)(2) of this section an amount computed as follows:

(i) Subtract **17.9** ~~16.5~~ cents from the price computed pursuant to paragraph (n)(1) of this section and multiply the result by 1.572;

(ii) Subtract 0.9 times the butterfat price computed pursuant to paragraph (l) of this section from the amount computed pursuant to paragraph (n)(3)(i) of this section; and

(iii) Multiply the amount computed pursuant to paragraph (n)(3)(ii) of this section by 1.17.

(o) Other solids price. The other solids price per pound, rounded to the nearest one-hundredth cent, shall be the U.S. average NASS dry whey survey price reported by the Department for the month, less **18.1** cents, with the result multiplied by 1.03.

(p) Somatic cell adjustment. The somatic cell adjustment per hundredweight of milk shall be determined as follows:

(1) Multiply .0005 by the weighted average price computed pursuant to paragraph (n)(1) of this section and round to the 5th decimal place;

(2) Subtract the somatic cell count of the milk (reported in thousands) from 350; and

(3) Multiply the amount computed in paragraph (p)(1) of this section by the amount computed in paragraph (p)(2) of this section and round to the nearest full cent.

(q) Advanced pricing factors. For the purpose of computing the Class I skim milk price, the Class II skim milk price, the Class II nonfat solids price, and the Class I butterfat price for the following month, the following pricing factors shall be computed using the weighted average of the 2 most recent NASS U.S. average weekly survey prices announced before the 24th day of the month.

(1) An advanced Class III skim milk price per hundredweight, rounded to the nearest cent, shall be computed as follows:

(i) ~~Following the procedure set forth in paragraphs (n) and (o) of this section, but u~~ Using the weighted average of the 2 most recent NASS U.S. average weekly survey prices announced before the 24th day of the month, compute a protein price and an other ~~solids price~~ **as follows:**

(A) A protein price per pound, rounded to the nearest one-hundredth cent, shall be computed as follows:

(I) Compute a weighted average of the amounts described in paragraphs (q)(1)(i)(A)(I)(*a*) and (*b*) of this section:

(*a*) The weighted average of the 2 most recent U.S. average NASS survey prices for 40-lb. block cheese announced before the 24th day of the month; and

(*b*) The weighted average of the 2 most recent U.S. average NASS survey prices for 500-pound barrel cheddar cheese (38 percent moisture) announced before the 24th day of the month;

(II) Subtract 16.5 cents from the price computed pursuant to paragraph (q)(1)(i)(A)(I) of this section and multiply the result by 1.383;

(III) Add to the amount computed pursuant to paragraph (q)(1)(i)(A)(II) of this section an amount computed as follows:

(*a*) Subtract 16.5 cents from the price computed pursuant to paragraph (q)(1)(i)(A)(I) of this section and multiply the result by 1.572;

(*b*) Subtract 0.9 times the butterfat price computed pursuant to paragraph (q)(3) of this section from the amount computed pursuant to paragraph (q)(1)(i)(A)(III)(*a*) of this section; and

(*c*) Multiply the amount computed pursuant to paragraph (q)(1)(i)(A)(III)(*b*) of this section by 1.17.

(B) An other solids price per pound, rounded to the nearest one-hundredth cent, shall be calculated by computing a weighted average of the 2 most recent U.S. average NASS dry whey survey prices announced before the 24th day of the month, subtracting 15.9 cents from this average, and multiplying the result by 1.03. ;

(ii) Multiply the protein price computed in paragraph (q)(1)(i) of this section by 3.1;

(iii) Multiply the other solids price per pound computed in paragraph (q)(1)(i) of this section by 5.9; and

(iv) Add the amounts computed in paragraphs (q)(1)(ii) and (iii).

(2) An advanced Class IV skim milk price per hundredweight, rounded to the nearest cent, shall be computed as follows:

(i) ~~Following the procedure set forth in paragraph (m) of this section, but u~~ Using the weighted average of the 2 most recent NASS U.S. average weekly survey prices announced before the 24th day of the month, ~~compute a~~ the advanced nonfat solids price shall be the NASS nonfat dry milk survey price reported by the department less 14 cents, with the result multiplied by 0.99.; ~~and~~

(ii) Multiply the advanced nonfat solids price computed in paragraph (q)(2)(i) of this section by 9.

(3) An advanced butterfat price per pound, rounded to the nearest one-hundredth cent, shall be calculated by computing a weighted average of the 2 most recent U.S. average NASS AA Butter survey prices announced before the 24th day of the month, subtracting 11.5 cents from this average, and multiplying the result by 1.20.

Table 3.
Calculations of Average 2004 Energy Costs from CDFA Survey

POWDER

		Electricity	Gas
Low Cost	**3 plants**	**0.0121**	**0.0226**
Medium Cost	**4 plants**	**0.0208**	**0.0253**
High Cost	**3 plants**	**0.0262**	**0.0472**
Average, Low & Medium		***0.0170***	***0.0241***
Average, All Plants		0.0198	0.0311

BUTTER

		Electricity	Gas
Low Cost	**4 plants**	**0.0061**	**0.0015**
High Cost	**4 plants**	**0.0120**	**0.0024**
Average		***0.0091***	***0.0019***

CHEESE

		Electricity	Gas
Low Cost	**3 plants**	**0.0075**	**0.0062**
High Cost	**4 plants**	**0.0094**	**0.0090**
Average	***7 plants***	***0.0086***	***0.0078***

WHEY

		Electricity	Gas
Average	***3 plants***	***0.0334***	***0.0226***

Data source: CDFA, detail on amended cost of production data issued January 2006. Data for CY 2004. See Exhibit 26.
Calculations: NMPF
Note: Plant groupings, including number of plants, correspond to those in Exhibit 25.

Roger Cryan

From: Wolter, Melissa - BLS [Wolter.Melissa@bls.gov]
Sent: Friday, January 06, 2006 3:37 PM
To: Roger Cryan
Subject: Industrial Natural Gas

Mr. Cryan,

The following is the definition for natural gas distribution:
This industry group comprises: (1) establishments primarily engaged in operating gas distribution systems (e.g., mains, meters); (2) establishments known as gas marketers that buy gas from the well and sell it to a distribution system; (3) establishments known as gas brokers or agents that arrange the sale of gas over gas distribution systems operated by others; and (4) establishments primarily engaged in transmitting and distributing gas to final consumers.

The following is the definition for the industrial sector customer (end user):
INDUSTRIAL: An energy-consuming sector that consists of all facilities and equipment used for producing, processing, or assembling goods. The industrial sector encompasses the following types of activity: manufacturing; agriculture, forestry, and fisheries; mining; and construction. Overall energy use in this sector is largely for process heat and cooling and powering machinery, with lesser amounts used for facility heating, and air conditioning.

The PPIs for Natural Gas Distribution are as follows:
055 Utility Natural Gas
0551 Residential Natural Gas
0552 Commercial Natural Gas
0553 Industrial Natural Gas
0554 Natural Gas to Electric Utilities

Sincerely,

Melissa Wolter
Economist
Producer Price Index
(202) 691-7881